

Internal Revenue Service
memorandum

CC:TL-N-1908-89
Brl:TDMoffitt

date: **FEB 6 1989**

to: District Counsel, Cincinnati, Ohio CC:CIN

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject:

Taxable years [REDACTED] and [REDACTED]

This is in response to your request for technical advice dated December 9, 1988, with regard to the above-referenced taxpayer.

ISSUE

Whether the issue of the deductibility of catalogue production expenses should be pursued in a case which would be appealable from the Tax Court to the Sixth Circuit in light of that circuit's decision in E.H. Sheldon & Co., v. Commissioner, 214 F.2d 655 (6th Cir. 1954), reversing 19 T.C. 481 (1952). 0162.04-01 and 0263.11-00

CONCLUSION

Under Golson v. Commissioner, 54 T.C. 742 (1970), Sheldon is the law of the circuit. The Sheldon opinion is incorrect in its conclusion that catalogue expenses are deductible in the year incurred. See Rev. Rul. 68-360, 1968-2 C.B. 197 and Best Lock Corporation v. Commissioner, 31 T.C. 1217 (1957). However, there is neither compelling Supreme Court opinion nor more recent Sixth Circuit opinions that would mandate that the Sixth Circuit reverse itself. Accordingly we do not recommend that this issue be litigated.

FACTS

The taxpayer in question is a manufacturer of automotive lighting and safety products, computing its income and expenses on the accrual basis. The taxpayer advertises its products through catalogues which it distributes to customers. The catalogues do not contain prices but have all other information

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necessary for placing an order with the company. An updated edition of the company's catalogue was issued in [REDACTED] [REDACTED] printings of the catalogue were made in that year totalling [REDACTED] copies. At least [REDACTED] of these catalogues were distributed to customers in [REDACTED]. During the period this edition of the catalogue was outstanding, flyers and supplements were issued as updates. A successor catalogue was issued in [REDACTED].

In [REDACTED] and [REDACTED] the company claimed deductions relating to the production of this edition of the catalogue on its tax returns, which deductions are at issue in this case.

DISCUSSION

The Sixth Circuit in reversing the Tax Court in Sheldon, held that the catalogue production costs of the taxpayer in that case were currently deductible. The Sheldon court faced a situation where the taxpayer produced catalogues for use as reference books and tools for the representatives of the taxpayer in making sales. As in the instant case, new editions of the catalogues were produced at intervals of several years.

In holding the expenses to be currently deductible the court framed the issue as: "...whether the catalog expense...is to be considered as an ordinary and necessary business expense in the nature of advertising, or whether it should be properly considered as a capital expenditure." Sheldon, supra, at 658. The court then found that because the taxpayer cannot show with reasonable certainty what benefits will be received from the catalogue production expenditures in future years the expense is not to be capitalized, but rather deducted in the year incurred. The difficulty with capitalizing such expenses arises from the necessity of more than a mere estimate of the relation between these expenses and income in later years.

The instant case, under this reasoning, presents an even stronger case for finding that the expenses are in the nature of advertising and as such currently deductible. The catalogues produced by [REDACTED] were distributed to customers rather than retained by representatives of the taxpayer as in Sheldon. This more closely resembles an advertising expense in that the asset to be capitalized was not retained by [REDACTED], but was rather distributed for use as the customers saw fit. The catalogues in Sheldon were of direct use to the representatives of the taxpayer in subsequent years. As such, these catalogues could more easily have been found to be capitalizable assets of the taxpayer, however, they were not.

The Tax Court in Sheldon had held that the apportionment of the cost of an asset to be capitalized over the period of that asset's usefulness need only be reasonable to require deduction over this period rather than in the year incurred. This

treatment of catalogue development expenses was repeated by the Tax Court in Best Lock, after the reversal of Sheldon by the Sixth Circuit. In Best Lock, supra, at 1235, the Tax Court said of Sheldon: "If the Sheldon case, supra, is not distinguishable on the facts, we adhere to the views expressed in our decision there, and with all due deference to the Court of Appeals for the Sixth Circuit, prefer to follow that decision here."

The Service in Rev. Rul. 68-360, adopted the position in Best Lock that catalogue production expenses creating an asset having a useful life greater than one year must be capitalized, and announced that the Service would not follow Sheldon.

At the time that the Sixth Circuit decided Sheldon, the law in the area of the deductibility of catalogue production expenses was unsettled. Unfortunately it is still so. Mundstock, Taxation of Business Intangible Capital, 135 Pennsylvania Law Review 1179 at 1198. While the Service and the Tax Court are clearly in favor of the capitalization of these expenses, there is no precedent applicable to the Sixth Circuit which would require such treatment.

There is support for the general proposition that expenses which produce an asset with utility in future years must be capitalized in both the Sixth Circuit and the Supreme Court. In Commissioner v. Lincoln Savings and Loan Association, 403 U.S. 345 (1971) the Supreme Court required the capitalization of additional premiums paid by the taxpayer to the FSLIC. These premiums would provide a specified benefit to the taxpayer in future years, dependent on a limited number of contingencies. The use of the premiums by the FSLIC and the limited contingencies influencing the nature of the benefit they would provide nearly allowed for a mathematically precise calculation of the utility to the taxpayer of these payments. This situation is clearly different from the case at hand where the Sixth Circuit has emphasized in Sheldon the uncertainty of the benefits to be derived in future years from catalogue production expenses. The instant case provides even greater uncertainty in the calculation of future benefits than did the Sheldon case as [REDACTED] did not retain the catalogues but rather distributed the vast majority directly to customers in the first year.

Louisville and Nashville Railroad Co. v. Commissioner, 641 F.2d 435 (6th Cir. 1981), aff'g in part and rev'g in part, 66 T.C. 962 (1976) (overhaul expenses of railroad cars), and Raymond Bertolini Trucking Company v. Commissioner, 736 F.2d 1120 (6th Cir. 1984) (construction bribes), represent Sixth Circuit cases decided subsequent to Sheldon which mandate capitalization. However, none of these cases deal with expenses which, like

advertising, provide highly uncertain return in future years. In Louisville and Nashville Railroad Co., the expenses to be capitalized were those required to overhaul railroad cars. The railroad cars would have a calculable extension of their useful lives as a result of the overhaul. Bertolini Trucking, dealt with the capitalization of kickbacks required by the primary contractor's site supervisor of subcontractors such as the taxpayer in that case. The kickbacks had specified utility in future years in that they allowed the subcontractor to continue on specific projects. Once again, this situation is clearly distinguishable from the uncertain future utility of catalogue production expenses as viewed by the Sixth Circuit. While these cases reinforce the doctrine that expenses which produce a separate asset with utility in future years must be capitalized, they by no means require the Sixth Circuit to overturn Sheldon.

Another argument against litigating this issue is the applicability of I.R.C. § 263A, which requires capitalization of expenses relating to real or tangible personal property produced by the taxpayer, to costs incurred after December 31, 1986. This section should effectively moot this issue in the future.

The settlement suggested in your request for technical advice wherein the taxpayer would be allowed to amortize the catalogue costs over a period of two years would appear to conform the desired tax treatment to a view of the future utility of the catalogue expenditure biased in favor of the taxpayer. Such a compromise would be the best outcome in light of our reluctance to support an appeal to the Sixth Circuit on this issue.

If you have any questions concerning this matter, please call Thomas Moffitt of this office at FTS 566-3521.

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